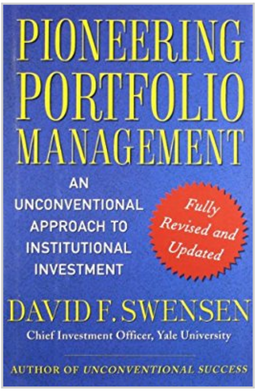

Pioneering Portfolio Management: An Unconventional Approach to Institutional Investment, Fully Revised and Updated

By David F. Swensen

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An indispensable roadmap for creating a successful investment program from Yale’s chief investment officer, David F. Swensen.

In the years since the now-classic *Pioneering Portfolio Management* was first published, the global investment landscape has changed dramatically -- but the results of David Swensen's investment strategy for the Yale University endowment have remained as impressive as ever. Year after year, Yale's portfolio has trumped the marketplace by a wide margin, and, with over $20 billion added to the endowment under his twenty-three-year tenure, Swensen has contributed more to Yale's finances than anyone ever has to any university in the country. What may have seemed like one among many success stories in the era before the Internet bubble burst emerges now as a completely unprecedented institutional investment achievement.

In this fully revised and updated edition, Swensen, author of the bestselling personal finance guide *Unconventional Success*, describes the investment process that underpins Yale's endowment. He provides lucid and penetrating insight into the world of institutional funds management, illuminating topics ranging from asset-allocation structures to active fund management. Swensen employs an array of vivid real-world examples, many drawn from his own formidable experience, to address critical concepts such as handling risk, selecting advisors, and weathering market pitfalls.

Swensen offers clear and incisive advice, especially when describing a counterintuitive path. Conventional investing too often leads to buying high and selling low. Trust is more important than flash-in-the-pan success. Expertise, fortitude, and the long view produce positive results where gimmicks and trend following do not.

The original *Pioneering Portfolio Management* outlined a commonsense template for structuring a well-diversified equity-oriented portfolio. This new edition provides fund managers and students of the market an up-to-date guide for actively managed investment portfolios.

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Editorial Review

Review
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Jack R. Meyer, President and CEO,

Harvard Management Company, Inc.

A masterful work by the master himself. We at Harvard wish that David Swensen would find a new job.

Barton M. Biggs, Chairman,

Morgan Stanley Dean Witter Investment Management

David Swensen is one of the best and most original fiduciaries of modern times. His thinking has survived the battlefields and it has worked for big money.

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About the Author
David F. Swensen is the chief investment officer of Yale University and the bestselling author of *Pioneering Portfolio Management*. He serves on the boards of TIAA, The Brookings Institution, Carnegie Institution, and Hopkins School. At Yale, where he produced an unparalleled two-decade investment record of 16.1 percent-per-annum returns, he teaches economics classes at Yale College and finance classes at Yale¹s School of Management. Mr. Swensen lives in New Haven, Connecticut.

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Introduction

When I wrote the introduction to the first edition of *Pioneering Portfolio Management* in early 1999, Yale's pathbreaking investment strategy had produced excellent results, both in absolute and relative terms, but had not yet been tested by adverse market conditions. In fact, Yale's return for the ten years ending June 30, 1998 amounted to 15.5 percent per annum, more than three full percentage points short of the S&P 500's 18.6 percent result. The endowment's deficit relative to the then-highest-performing asset class of domestic equity caused naysayers to question the wisdom of undertaking the difficult task of creating a well-diversified equity-oriented portfolio.

The years following the first edition's publication proved the worth of Yale's innovative asset allocation. The continuation of the bull market in 1999 and early 2000 produced wonderful results for Yale, culminating in a 41.0 percent return for the year ending June 30, 2000, a result that trounced the average endowment return of 13.0 percent. Yet, the real test of Yale's approach took place in 2001 and 2002 as the Internet bubble burst and marketable equities collapsed. Yale posted positive returns of 9.2 percent in 2001 and 0.7 percent in 2002, even as the average endowment reported deficits of 3.6 percent and 6.0 percent, respectively. In short, equity orientation continued to drive Yale's strong results, while diversification kicked in to preserve the university's assets.

From a market perspective, the vantage point of early 2008 differs dramatically from that of early 1999. For the ten years ending June 30, 2007, Yale's 17.8 percent return emphatically exceeded the S&P 500's 7.1 percent. Twenty-year results tell a similar tale with Yale's 15.6 percent trumping the S&P's 10.8 percent. In fact, Yale's conspicuous success attracted the attention of many investors, making the university's strategy seem less radical and more sensible, less pioneering and more mainstream.

In spite of widespread imitation of Yale's portfolio management philosophy, the university posted stunning returns relative to peers. For the year ended June 30, 2007, Yale reported a 28.0 percent return, which exceeded the results of all of the educational institutions that participated in the 2007 Cambridge Associates

Annual Analysis of College and University Pool Returns. More significantly, Yale's results led the pack for five-, ten-, and twenty-year periods. The university's pioneering portfolio management works in theory and in practice.

The most important measure of endowment management success concerns the endowment's ability to support Yale's educational mission. When I arrived at Yale in 1985, the endowment contributed $45 million to the university's budget, representing a century-low 10 percent of revenues. For Yale's 2009 fiscal year, in large part as a result of extraordinary investment returns, the endowment will transfer to the budget approximately $1,150 million, representing about 45 percent of revenues. High quality investment management makes a difference!

Institutions versus Individuals

When I wrote my second book, *Unconventional Success,* I characterized its message as "a sensible investment framework for individuals," in contrast to the institutional focus of *Pioneering Portfolio Management.* I erred in describing my target audiences. In fact, I have come to believe that the most important distinction in the investment world does not separate individuals and institutions; the most important distinction divides those investors with the ability to make high quality active management decisions from those investors without active management expertise. Few institutions and even fewer individuals exhibit the ability and commit the resources to produce risk-adjusted excess returns.

The correct strategies for investors with active management expertise fall on the opposite end of the spectrum from the appropriate approaches for investors without active management abilities. Aside from the obvious fact that skilled active managers face the opportunity to generate market-beating returns in the traditional asset classes of domestic and foreign equity, skilled active managers enjoy the more important opportunity to create lower-risk, higher-returning portfolios with the alternative asset classes of absolute return, real assets, and private equity. Only those investors with active management ability sensibly pursue market-beating strategies in traditional asset classes and portfolio allocations to nontraditional asset classes. The costly game of active management guarantees failure for the casual participant.

No middle ground exists. Low-cost passive strategies, as outlined in *Unconventional Success,* suit the overwhelming number of individual and institutional investors without the time, resources, and ability to make high quality active management decisions. The framework outlined in *Pioneering Portfolio Management* applies to only a small number of investors with the resources and temperament to pursue the grail of risk-adjusted excess returns.

The World of Endowment Management

The fascinating activity of endowment management captures the energy and imagination of many talented individuals charged with stewardship of institutional assets. Investing with a time horizon measured in centuries to support the educational and research missions of society's colleges and universities creates a challenge guaranteed to engage the emotions and the intellect.

Aside from the appeal of the eleemosynary purposes that endowments serve, the investment business contains an independent set of attractions. Populated by unusually gifted, extremely driven individuals, the institutional funds management industry provides a nearly limitless supply of products, a few of which actually serve fiduciary aims. Mining the handful of gems from the tons of mine ore provides intellectually stimulating employment for the managers of endowment portfolios.

The knowledge base that provides useful support for investment decisions knows no bounds. A rich understanding of human psychology, a reasonable appreciation of financial theory, a deep awareness of history, and a broad exposure to current events all contribute to development of well-informed portfolio strategies. Many top-notch practitioners confess they would work without pay in the endlessly fascinating money management business.

The book begins by painting the big picture, discussing the purposes of endowment accumulation and examining the goals for institutional portfolios. Articulation of an investment philosophy provides the underpinnings for developing an asset-allocation strategy -- the fundamentally important decision regarding the portion of portfolio assets devoted to each type of investment alternative.

After establishing a framework for portfolio construction, the book investigates the nitty-gritty details of implementing a successful investment program. A discussion of portfolio management issues examines situations where real world frictions might impede realization of portfolio objectives. Chapters on traditional and alternative asset classes provide a primer on investment characteristics and active management opportunities, followed by an outline of asset class management issues. The book closes with some thoughts on structuring an effective decision-making process.

The linearity of the book's exposition of the investment process masks the complexities inherent in the portfolio management challenge. For example, asset allocation relies on a combination of top-down assessment of asset class characteristics and bottom-up evaluation of asset class opportunities. Since quantitative projections of returns, risks, and correlations describe only part of the scene, top-notch investors supplement the statistical overview with a ground-level understanding of specific investments. Because bottom-up insights into investment opportunity provide information important to assessing asset class attractiveness, effective investors consider both top-down and bottom-up factors when evaluating portfolio alternatives. By beginning with an analysis of the broad questions regarding the asset allocation framework and narrowing the discussion to issues involved with managing specific investment portfolios, the book lays out a neat progression from macro to micro, ignoring the complex simultaneity of the asset management process.

Rigorous Investment Framework

Three themes surface repeatedly in the book. The first theme centers on the importance of taking actions within the context of an analytically rigorous framework, implemented with discipline and undergirded with thorough analysis of specific opportunities. In dealing with the entire range of investment decisions from broad-based asset allocation to issue-specific security selection, investment success requires sticking with positions made uncomfortable by their variance with popular opinion. Casual commitments invite casual reversal, exposing portfolio managers to the damaging whipsaw of buying high and selling low. Only with the confidence created by a strong decision-making process can investors sell mania-induced excess and buy despair-driven value.

Establishing an analytically rigorous framework requires a ground-up examination of the investment challenges faced by the institution, evaluated in the context of the organization's specific characteristics. All too often investors fail to address the particular investment policy needs of an institution, opting instead to adopt portfolio structures similar to those pursued by comparable institutions. In other cases, when evaluating individual investment strategies, investors make commitments based on the identity of the co-investors, not on the merits of the proposed transaction. Playing follow-the-leader exposes assets to substantial risk.

Disciplined implementation of investment decisions ensures that investors reap the rewards and incur the costs associated with the policies adopted by the institution. While many important investment activities require...

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